DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report October 2022

Performance

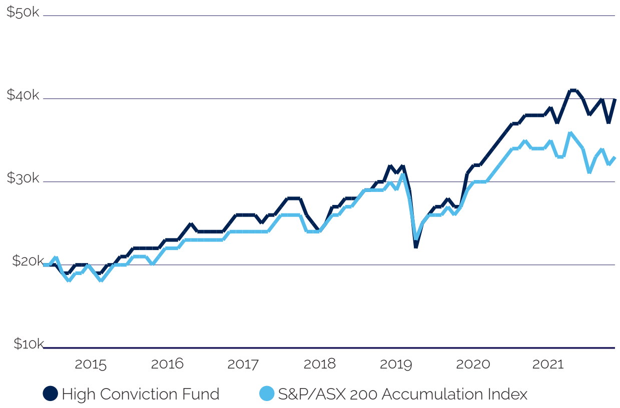
DNR Capital Australian Equities High Conviction Fund increased 6.04% (net of fees) in October, in line with the S&P/ASX 200 Accumulation Index. Over the last 12 months, the Fund increased by 2.87%, outperforming the Index by 4.88% (net of fees).

Net active return as at 31 October 2022

	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	Incep.* p.a. %
High Conviction Fund	6.04	0.33	-3.69	2.87	9.06	9.26	9.65
S&P/ASX 200 Accumulation Index	6.04	0.67	-5.41	-2.01	4.82	7.18	7.20
Excess return	**0.00**	**-0.34**	**1.72**	**4.88**	**4.24**	**2.08**	**2.45**

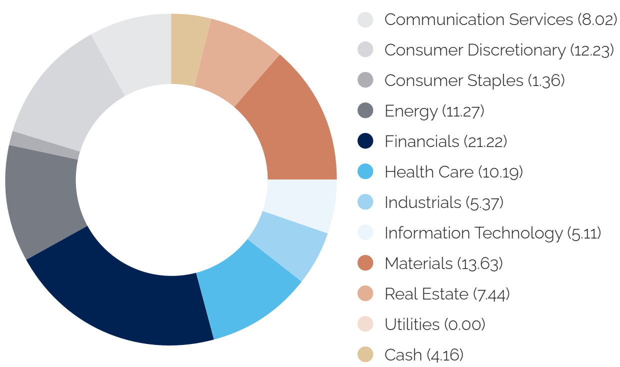
* Inception Date—June 2015.
Source: DNR Capital and Mainstream Fund Services.
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry/exit fees or taxation.

Growth of $20,000 since inception



Source: DNR Capital and Mainstream Fund Services

Sector weightings %



Source: DNR Capital and Mainstream Fund Services

Top 5 active holdings

Security details
The Lottery Corporation (TLC)
National Australia Bank (NAB)
Woodside Energy Group (WDS)
CSL (CSL)
QBE Insurance Group (QBE)

Source: DNR Capital and Mainstream Fund Services

Monthly top contributors and detractors

Top 3 contributors
Domino's Pizza Enterprises (DMP)
Fortescue Metals Group (FMG, no holding)
Woodside Energy Group (WDS)

Top 3 detractors
Commonwealth Bank of Australia (CBA, no holding)
Westpac Banking Corporation (WBC, no holding)
CSL (CSL)

Source: DNR Capital and Mainstream Fund Services

Experienced portfolio managers

Jamie Nicol
Chief Investment Officer

Scott Bender
Portfolio Manager

Performance attribution

Contributors

- **Domino's Pizza Enterprises (DMP):** outperformed during the month, bouncing off its previous month lows on no stock specific news. Subsequent AGM trading updates highlighted ongoing pressures in Europe which the group continues to manage in the face of steep inflation.
- **Fortescue Metals Group (FMG, no holding):** fell over the month as concerns remain that Chinese steel production will remain soft, however there are tentative signs that COVID-19 restrictions may be easing.
- **Woodside Energy Group (WDS):** outperformed during the month as global energy prices rebounded. The primary news flow for energy was the OPEC+ decision to cut the production quota by two million barrels per day, despite US pressure to increase supply. The cut will not physically equal two million barrels, given that actual production was much lower than the previous quota. This reinforces our belief that the ability to increase supply beyond current levels is limited, providing support to the oil price.

Detractors

- **Commonwealth Bank of Australia (CBA, no holding):** banks bounced due to higher interest rates feeding through to better margins in the short term. In the longer term we remain concerned regarding the impact of higher rates on bad debts, higher costs and competition eating away improved margins.
- **Westpac Banking Corporation (WBC, no holding):** banks bounced due to higher interest rates feeding through to better margins in the short term. In the longer term we remain concerned regarding the impact of higher rates on bad debts, higher costs and competition eating away improved margins.
- **CSL (CSL):** despite providing positive commentary around the continued improvement in plasma collection volumes at the AGM, CSL struggled to match the strong index return during October. Current collection volumes are continuing to improve and are now above pre COVID-19 levels.

Fund and market review

The S&P/ASX 200 Accumulation Index was up 6.04% during the period. Financials (+12.2%) was the best performing sector, with the big banks benefitting from increasing net interest margins while maintaining record low bad debts. A-REITs (+9.9%) also outperformed, with bond rates retreating from their highs, feeding directly into lower expectations for property capitalisation rates. Consumer Staples (-0.2%) was the worst performing sector, with a poor quarterly report from Coles Group (COL -0.6%) highlighting a moderation of operating conditions from COVID-19 highs. Materials (-0.1%) also underperformed, with iron ore prices receding with a weaker Chinese economic backdrop.

This month we once again review developments within inflation and interest rate movements, given their importance to markets at present. We also discuss major moves in currencies and their impact on growth and policy development and check in on valuations.

Powell surprises

The market has been rallying on hope Jerome Powell, Chair of the US Federal Reserve (Fed) would slow down interest rate increases which would increase the probability of a soft landing for the economy.

Unfortunately inflation continues to remain stubbornly high and the Fed has reacted accordingly. The Federal Open Market Committee (FOMC) raised rates by 75bps, their 4th +75bp hike in succession, bringing the rate to a range of 3.75 - 4%. In terms of the outlook the Fed highlighted:

- "Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures"
- "The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time"
- "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments"
- "The Committee is strongly committed to returning inflation to its 2% objective"
- "It is very premature to be thinking about pausing. We have a ways to go".

The market reacted negatively interpreting the Feds statements as a determination to lift rates regardless of the economic consequences. Note the Fed has a dual mandate needing to balance employment with inflation. At present unemployment is low and inflation strong. As unemployment rises, political pressure will increase.

The table below highlights that consensus currently expects Powell to succeed (and other central banks) and that inflation will be back at the target range by CY24. The market has been hopeful regarding inflation for the past two years. Initially there were discussions about it being transitory and then the market hung onto declines in commodity prices. We see this level of expectation as unambiguously bearish. Either the market is wrong and inflation will remain higher for longer which would have negative valuation implications, or central banks need to cause a decent economic slowdown, likely recession to reduce demand and cause inflation to fall.

Inflation expectations

	Country/Region	CY '19	CY '20	CY '21	CY '22	CY '23	CY '24
G7							
	Canada	2.0	0.7	3.3	6.8	3.4	2.0
	France	1.3	0.5	2.1	5.9	4.6	1.9
	Germany	1.4	0.4	3.2	8.5	6.4	1.9
	Italy	0.7	-0.2	1.9	7.7	5.3	1.9
	Japan	0.5	-0.0	-0.2	2.2	1.5	1.0
	United Kingdom	1.8	0.9	2.6	9.0	6.5	3.0
	United States	1.8	1.2	4.7	8.0	3.6	2.4
Asia Pacific							
	Australia	1.6	0.8	2.9	6.4	4.4	2.7
	China	2.9	2.5	0.9	2.2	2.3	2.3

Source: FactSet

Signs of a slowdown

The economy in Australia and the US has been resilient in the face of higher interest rates. Consumer sentiment has been falling but consumer spending remains robust, supported by excess savings during COVID-19. House prices are falling and construction is likely peaking but unemployment remains very low. Softer unemployment will be helpful for markets as it would indicate that central banks are having success with their policies.

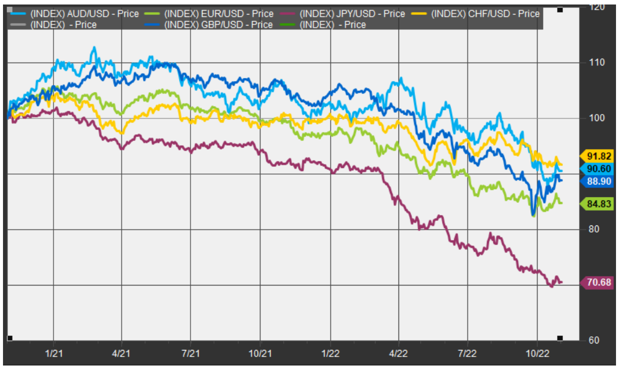
Australian unemployment rate

Source: FactSet

Currencies

One of the unusual features of this cycle is the big move in currencies with substantial strength in the US$ against most other currencies. Investors are struggling to invest in Europe, emerging markets or China. US is lifting interest rates aggressively and thereby attracting capital. The implication of this becomes circular. The move in currency helps the US export inflation to other countries who then need to lift interest rates causing economic slowdown. In addition, emerging markets face significant stress from a higher US$ debt burden and US$ oil costs. This in turn makes the US appear more attractive for investors. This crisis is more a sovereign debt crisis than a bank crisis and governments continue to grapple with the best way to handle it (see UK for an example).

Currencies



Source: FactSet

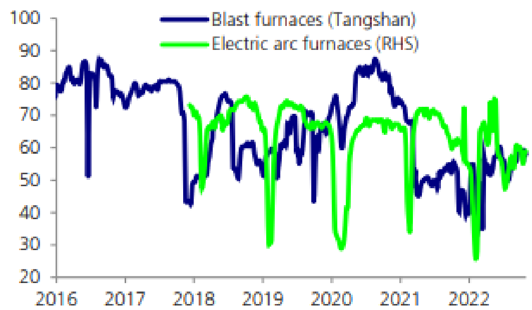
China

China seems out of sync with the rest of the world. It is still dealing with COVID-19 lockdowns, and is trying to unravel over investment in housing but has lower inflation.

Chinese political machinations appear to be moving away from capitalism which increases risks for investors. China is trying to increase the self-sufficiency of its economy and reduce reliance on property where there is over investment and declining demographics.

Property sale declines have likely widened. High frequency data showed October property sales in 30 major cities saw a larger y/y decline to -18% y/y from -14% y/y previously, partly due to tighter COVID-19 restrictions. This seems to be feeding into softer steel rates which has implications for Australia.

Steel furnaces operating rate (%)

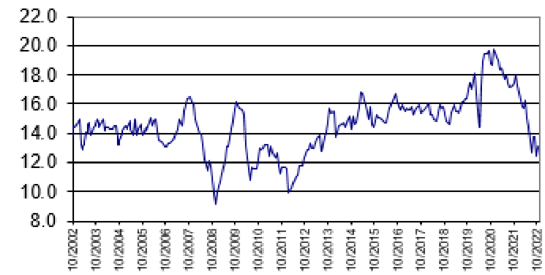


Source: CEIC, Wind, UBS estimates

At the same time China has the potential to emerge out of COVID-19 once vaccinations rates increase. As always China and its policy objectives remain a little obscure.

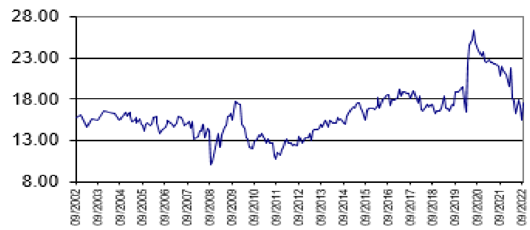
Valuations

Rolling forward per trend - Australian market



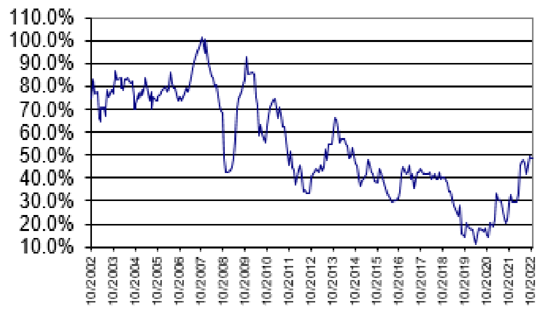
Source: FactSet

Rolling forward per trend - US market



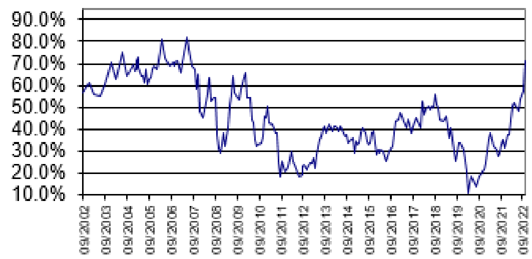
Source: FactSet

Bond yield on earnings yield - Australian market



Source: FactSet

Bond yield on earnings yield - US market



Source: FactSet

At a headline level the PE for Australia and the US looks in line with long-term averages, suggesting a significant valuation adjustment has occurred reflecting the concerns we have outlined regarding slowing economic growth. However looking below the surface we note that excluding resources and energy, the market still seems a little inflated. Furthermore, US equity yields versus bond yields are no longer so attractive (thanks to the large move in bond yields). Perhaps this makes bonds a little more attractive relative to how they have appeared for some time.

We also note that highly speculative companies are starting to fall aggressively (which is a good sign). When the heat disappears from these companies we can begin to look for a market bottom. Some high profile non profitable technology businesses have already shown signs of reverting beyond their elevated pre-COVID-19 levels.

Fund positioning

We consider The Lottery Company (TLC) as a high-quality defensive position, with strong pricing power. It is the monopoly operator of regulated lottery businesses in all states excluding WA and the average license expiry is 2049, with individual licenses running for up to 50 years. The continued trend towards digital play supports incremental margin expansion and a higher frequency of play. Volumes can fluctuate with jackpot sequences; however long-term growth outcomes have proven very resilient through many economic cycles. These underlying trends of consistent top line growth coupled with ongoing margin expansion support the outlook for ongoing strong defensive profit growth.

Fund facts

Inception date: June 2015

Minimum initial investment: $20,000

Risk level: High

Management fee: 0.90% (inclusive GST and RITC)

Performance fee: Nil

Entry/exit fees: Nil

Buy/sell spread: +0.20%/-0.20%

Valuation and unit pricing frequency: Each business day

Distribution frequency: Semi-Annual

Responsible Entity: The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies.

About DNR Capital and the Fund

Concentrated: Investing in 15-30 highest conviction, quality large cap Australian listed equities.

Style neutral and quality focussed: A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Experienced and aligned team: The portfolio managers have more than 50 years of combined investment experience and are invested alongside our clients.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

Disclaimer

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Office address
Level 23
307 Queen Street
Brisbane QLD 4000

Postal address
GPO Box 3263
Brisbane QLD 4001

Telephone
07 3229 5531

Email
info@dnrcapital.com.au

Website
dnrcapital.com.au

DNRHCF. 3.00.2210